

# Gifted Carve-Outs in Asset Sales under §363 Still Controversial

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**Editor's Note:** Please refer to the October 2009 Journal article by Damian S. Schaible and Eli J. Vonnegut entitled "SPM Manufacturing to Journal Register: Indicators of a Successful 'Gift Plan'" for a discussion of another recent case on this issue in the context of a chapter 11 plan.

When a chapter 11 debtor seeks to sell assets under §363 of the Bankruptcy Code and its debtor-in-possession (DIP) or senior secured lenders are undersecured, structuring an adequate arrangement to enable general unsecured creditors to see some recovery post-sale may be one of the more challenging tasks for an unsecured creditors' committee and other parties involved in the process.



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New authority has emerged in recent years approving arrangements in §363 sales for the carving out and/or setting aside of certain sale proceeds or other assets from the security interests of a debtor's DIP or senior secured lenders. The carve-outs are for the benefit of the debtor's general unsecured creditors and may often provide the best or only realistic opportunity for a meaningful recovery for general unsecured creditors where the debtor's DIP and/or secured creditors are undersecured.

These carve-outs have generated controversy and litigation when they involve the additional component of bypassing or failing to first satisfy the claims of priority and/or administrative creditors whose claims, under §§503, 507 and 1129 of the Code, are senior to those of general unsecured creditors. In such situations, the carve-out is typically justified by the parties supporting it as merely involving a "gifting" of a portion of senior secured or DIP lender's collateral to the debtor's general unsecured creditors. The courts approving these collateral carve-outs have agreed that they do not constitute property of the bankruptcy estate and

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are not prohibited by the distribution and priority scheme embodied in the Code.

Not all courts have agreed with the propriety of these §363 sale "gifting" carve-outs. Most recently, in *On-Site Sourcing Inc.*, No. 09-10816, 2009 WL 1789331 (Bankr. E.D. Va. 2009), the bankruptcy court refused to approve a gifting carve-out. The court held that, among other things, it contravened the absolute-priority rule in §1129 since junior, unsecured creditors were to be paid at the expense of senior, priority creditors.<sup>1</sup> The legal interpretation given

## Feature

by the *On-Site* court to the permissibility of carve-out and gifting provisions in §363 sales amplifies the contention and split of authority that remains on the issue. It also emphasizes the importance to those involved in planning and staging a 363 sale of understanding the views of the courts in the applicable jurisdiction on such matters.

### Background of the On-Site Decision

The 363 asset sale proposed in *On-Site* had a fact pattern familiar to many chapter 11 practitioners. The debtor filed first-day motions to approve DIP financing, as well as approve a stalking-horse sale agreement and auction process for the sale of its assets. The debtor's DIP and prepetition secured lender was also to serve as the stalking-horse bidder. The prepetition secured debt totaled approximately \$35 million, and under the proposed DIP financing, approximately \$40 million would be advanced to the debtor, which would be used, in part, to pay off the

existing prepetition secured debt. Under the sale terms, the stalking-horse bidder proposed to purchase the assets for \$28 million. No other bidders submitted competing bids at the auction, leaving the stalking-horse bidder as the highest and best bid, which the debtor sought to have approved.

The unsecured creditors' committee initially opposed the sale and ultimately negotiated a consensual resolution with the debtor and stalking-horse bidder/DIP lender. Among the key terms of this resolution, in exchange for the committee's agreement to support the sale were: (1) the DIP lender's deficiency claim would be deemed waived; (2) the stalking-horse bidder would agree to exclude from the assets it was purchasing from the debtor: (a) the debtor's interest in certain tax refunds, (b) 100 percent of chapter 5 causes of action against the debtor's insiders and (c) 35 percent of all other chapter 5 causes of action; and (3)

the stalking-horse bidder would agree to carve out and fund the sum of \$132,500, plus a one-half interest in the debtor's tax refunds to a trust, to be created for the exclusive benefit of the debtor's general, unsecured creditors.<sup>2</sup>

### Court's Concerns and Modifications to the Sale Agreement

At a hearing on the approval of the sale under the terms negotiated with the creditors' committee, the court advised the parties (and restated in its written opinion) that it would not approve the sale unless (1) certain proposed releases to be given to three of the debtor's insiders that the stalking-horse bidder contemplated retaining with the business post-sale were deleted, and (2) the provision for creation of the unsecured creditor trust and the stalking horse's gifting of the \$132,500 in sale proceeds and one-half interest in the debtor's tax refunds was removed from

<sup>2</sup> *Id.* at 4.

<sup>1</sup> *Id.* at 9.

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the agreement.<sup>3</sup> The terms of the sale were subsequently modified to satisfy the court's concerns, and thereafter, the court approved the sale to the stalking-horse bidder.<sup>4</sup>

In its decision approving the sale entered on June 22, 2009, the court went into significant detail to examine both the factual background of the sale as well as the legal reasons why it believed the sale was not proper without the modifications it had insisted upon as a condition to approval.<sup>5</sup> The court began its analysis by commenting on the speed with which the sale process and DIP facility were embarked upon and approved, and specifically noted that the debtor filed its 363 sale motion and its DIP financing shortly after midnight of the first day of its chapter 11 filing and an expedited hearing on the motions was heard a day later.<sup>6</sup>

With regard to the proposed releases to the debtor's insiders, the court indicated that such provisions impermissibly "furthered a *sub rosa* plan of reorganization" and that no adequate business reason to justify such releases had been shown.<sup>7</sup> It then devoted the remainder of its opinion to discussing its view on the impermissibility of the proposed carve-out of sale proceeds and other assets to the unsecured creditor trust.<sup>8</sup>

The court characterized the creditors' committee's argument that the proceeds in question were a gifting from the DIP lender to the debtor's unsecured creditors as "disingenuous."<sup>9</sup> It disagreed with the committee's assertion that the proceeds were really a distribution of the DIP lender's property and that it was entitled to do what it wanted to with them.<sup>10</sup> The court held that the "proceeds from the sale of property of the estate are property of the estate," and that is not changed by the fact that the property sold is subject to an encumbrance.<sup>11</sup>

It held that the greater problem with the proposed carve-out to the unsecured creditor trust is that it would have "effectively evaded the carefully-

crafted scheme of the Chapter 11 plan confirmation process."<sup>12</sup> The court stated that the carve-out and unsecured creditor trust provisions of the proposed sale were "contrary to the scheme of distribution envisioned in both a Chapter 7 and Chapter 11 liquidation," since they would ensure that general unsecured creditors were paid ahead of priority and administrative creditors.<sup>13</sup>

The *On-Site* court specifically found that §1129(a)(7), (a)(8) and (a)(9)<sup>14</sup> would all be infringed upon and/or circumvented by the proposed carve-out and gifting provisions of the sale, since general unsecured creditors would receive distributions at the expense of higher, impaired claims such as priority claims and administrative claims that would not be paid in full.<sup>15</sup> The court also recognized that while consent by an impaired class of creditors to a certain treatment in a chapter 11 plan may be an alternative means to satisfy the requirements of §1129, the *On-Site* sale process was "quick," and it was not clear to the court that the adversely-affected parties had any "meaningful notice" of the unsecured creditor trust provisions of the sale agreement.<sup>16</sup>

At bottom, the court held that the carve-out and unsecured creditor trust proposed by the debtor and committee would effectively deprive administrative and priority creditors of their rights under §1129(a)(7) and (a)(9), as well as their rights under §1125 to adequate information to make an informed decision with respect to a plan of reorganization and their rights to object to such a plan under §1126.<sup>17</sup> Finally, the court held that despite the committee's success in negotiating an increase in the proposed sale price of \$132,000 to fund the unsecured creditor trust, it would be "unfair to successfully increase an inadequate sale price to a fair sale price,

<sup>12</sup> *Id.* at 8.

<sup>13</sup> *Id.*

<sup>14</sup> Section 1129(a)(7) addresses the necessity that, for confirmation of a chapter 11 plan, each holder of a claim in an impaired class of claims or interests, either accept the proposed plan, or receive or retain under the plan, property of a value that is "not less than the amount such holder would so receive or retain if the debtor were liquidated under Chapter 7." In a chapter 7 liquidation, a bankruptcy trustee would be required to follow the priority distribution scheme set forth in §726 of the Code, which places priority and administrative claims ahead of general, unsecured claims. Section 1129(a)(9)(A) and (B) addresses priority and amount of payment that holders of priority claims under §507 (including administrative expense claims under §503(b)) are entitled to as a condition to confirmation of a plan, absent agreement by such holders to a different treatment.

<sup>15</sup> *Id.* at 9.

<sup>16</sup> *Id.* at 10.

<sup>17</sup> *Id.*

but then keep that benefit for one's own constituency at the expense of other, more senior classes of creditors."<sup>18</sup>

## On-Site Contrasts with Other Recent Decisions

The *On-Site* decision exemplifies the ongoing conflict in the various jurisdictions with respect to the permissibility of unsecured creditor carve-out and gifting arrangements in §363 sales. Two recent decisions out of the Delaware Bankruptcy Court, which issued rulings essentially contrary to *On-Site*, highlight this conflict. In *In re World Health Alternatives Inc.*, 344 B.R. 291 (Bankr. D. Del. 2006), the court was presented with a fact pattern with striking similarities to *On-Site* in many respects, yet reached the opposite conclusion. The *World Health* debtors sought court approval of a 363 sale to a stalking-horse bidder, which was also the debtor's prepetition secured and DIP lender. Following an auction process that resulted in no higher or better bids than the stalking-horse bid, the creditors' committee negotiated a proposed settlement with the debtors and stalking-horse bidder. Under the terms of the proposed settlement, the committee agreed to withdraw its objections to the sale, and in exchange, among other things, the DIP lender agreed to waive its deficiency claim and to pay to and for the "exclusive benefit of the debtors' general unsecured creditors," a collateral carve-out from its lien of \$1,625,000 to be either distributed to general unsecured creditors or used to investigate and prosecute causes of action other than actions against the DIP lender.<sup>19</sup>

The U.S. Trustee objected to the proposed settlement as an impermissible gifting outside of a plan that violated §1129. The court, in ruling on the approval of the settlement, first noted the general bankruptcy principle favoring settlements and in particular found that the settlement proposed in this case represented "global peace among the Debtors, the Committee and [the DIP lender]."<sup>20</sup>

The court held (in contrast to the court's holding in *On-Site*) that "the payout to the general unsecured creditors is a carve-out of the secured creditor's

<sup>18</sup> *Id.*

<sup>19</sup> *Id.* at 294.

<sup>20</sup> *Id.* at 296.

<sup>3</sup> *Id.* at 7-8.

<sup>4</sup> *Id.* at 1.

<sup>5</sup> *Id.* at 5-9.

<sup>6</sup> *Id.* at 1.

<sup>7</sup> *Id.* at 7. A break-up fee of \$560,000 plus expense reimbursement of up to \$250,000 were also proposed. The court ultimately determined that the break-up fee was an unnecessary "excess" and refused to approve it. *Id.* at 11.

<sup>8</sup> *Id.* at 7-11.

<sup>9</sup> *Id.* at 8.

<sup>10</sup> *Id.* at 7.

<sup>11</sup> *Id.*

lien and not estate property. I believe the Bankruptcy Code does not prohibit this arrangement and reported cases so hold.”<sup>21</sup> The court further ruled that contrary to the arguments of the U.S. Trustee, the requirements in §1129 and the absolute priority rule—with respect to the absence of distributions to be paid to senior claimholders under the settlement—were not implicated, since the settlement did not arise in the context of a chapter 11 plan.<sup>22</sup> However, it indicated that even if the absolute priority rule did apply to settlements outside of a chapter 11 plan setting, this would not prohibit the ordinary carve-out set forth in the settlement at issue from being approved.<sup>23</sup>

In August 2008, another decision was issued out of the Delaware bankruptcy court. In *In re TSIC Inc.*, 393 B.R. 71 (Bankr. D. Del. 2008),<sup>24</sup> relying on *World Health*, the court also upheld a proposed carve-out and gifting settlement proposed in a §363 asset sale. The *TSIC* gifting/carve-out involved a sale to a stalking-horse bidder, which, in exchange for the creditors’ committee’s support for the sale, agreed to provide and fund a portion of the sale consideration to a trust exclusively for the benefit of its general unsecured creditors.<sup>25</sup> The court, agreeing with the *World Health* decision,<sup>26</sup> held that in a §363 sale, the absolute-priority rule is “not violated in substance or spirit” by a carve-out of nonestate funds by a noncreditor, stalking-horse entity, to be made exclusively for the benefit of general unsecured creditors, even if that means that senior claimants will not be paid first with such funds.<sup>27</sup>

A third view and approach, falling somewhere among the viewpoints of the *On-Site*, *World Health* and *TSIC* courts, emerged in the March 2007 decision of the Second Circuit Court of Appeals in *In re Iridium Operating LLC*, 478 F.3d 452 (2d Cir. 2007). *Iridium*, as the court itself acknowledged, involved

a very complex settlement and a set of facts different from the other cases.<sup>28</sup> The *Iridium* settlement contemplated the establishment of a litigation trust which, with the consent of the debtor’s lenders, would have caused estate funds to be placed in the trust to enable the continued litigation of claims against a certain insider and priority creditor of the debtor.<sup>29</sup> Thereafter, proceeds from recoveries made to the trust would be split between the general unsecured creditors and the lenders.<sup>30</sup> The insider/priority creditor objected to the proposed settlement as violating the absolute priority rule. The court held that a “rigid, *per se* rule” regarding whether the absolute priority rule applied to carve-outs for unsecured creditors was not appropriate in the context of preplan settlements.<sup>31</sup> The court further held that, although in any proposed pre-plan settlement dealing with distributions to creditors compliance with the Bankruptcy Code’s priority scheme will often be the dispositive factor, if other factors “weigh heavily” in favor of the settlement, the bankruptcy court could, at its discretion, endorse a settlement that did not comply “in minor respects” with the absolute priority rule.<sup>32</sup>

### On-Site’s Effect on Future 363 Sales Involving Gifting Carve-Outs to Unsecured Creditors

There is a related line of authority consistent with the concept that carve-outs in 363 sales are not only permissible, but perhaps necessary for approval of the sale in some circumstances where the DIP or secured lender is undersecured. This line of authority holds that in order for a debtor to meet the sound business purpose and justification standard generally required for approval of a 363 sale, it must be shown that some portion of the sale proceeds or value are flowing through to benefit the debtor’s unsecured creditors.<sup>33</sup> Creditors’ committees and others arguing in favor of such carve-outs frequently cite this principle as additional support in objecting to a sale that does not provide meaningful

value for general unsecured creditors. The *On-Site* court’s decision could negate or limit the effectiveness of a sale objection on such basis unless the objecting party essentially conceded from the outset that the proceeds or value to be left behind for creditors would be distributed in compliance with §1129.

Whether the constraints placed by the *On-Site* court on carve-outs of sale proceeds for general unsecured creditors in 363 sales will signal any shift in other jurisdictions to confront the issue in future cases remains to be seen. Significant differences of opinion continue to exist among the courts as to whether such carve-outs involve “property of the estate” or are otherwise subject to the absolute-priority rule and other plan-confirmation requirements in §1129. The solutions for a debtor in a jurisdiction adopting the *On-Site* court’s view will most likely be limited to either tailoring any carve-out of sale proceeds to ensure that contemplated distributions satisfy the absolute-priority rule, which may result in no distributions for general unsecured creditors, or seeking approval of the gifting carve-out as part of an actual plan that satisfies the requirements of §1129.

### Conclusion

The *On-Site* court expressed much concern with regard to the speed of the sale process and the possible lack of meaningful notice to priority creditors of the effect of the gifting carve-out on their claims. Its comments suggest a cautionary lesson for those proposing such gifting carve-outs in future cases in jurisdictions leaning towards the *On-Site* court’s position. Rapid-fire 363 sales are frequently justified as necessary in order to prevent further diminishment of the value of the debtor’s assets or enterprise. However, in jurisdictions leaning towards the *On-Site* court’s view, pursuing a 363 sale with a gifting carve-out without providing meaningful time and opportunity for review by priority creditors may be more likely to result in no sale being approved or at least a delay in the sale, which may cause the very decline in asset value that the sale proponents sought to avoid. ■

<sup>21</sup> *Id.* at 297.

<sup>22</sup> *Id.* at 298.

<sup>23</sup> *Id.*

<sup>24</sup> Prior to the sale of its assets, *TSIC Inc.* was known as *Sharper Image Corp.*

<sup>25</sup> *Id.* at 74.

<sup>26</sup> Both *World Health* and *TSIC* dedicated significant attention to examining and/or differentiating two previous circuit court decisions that dealt with gifting carve-out issues. *In re SPM Manufacturing Corp.*, 984 F.2d 1305 (1st Cir. 1993), and *In re Armstrong World Industries Inc.*, 432 F.3d 507 (3d Cir. 2005). *Armstrong* arose in connection with a carve-out proposed as part of a plan of reorganization that was unquestionably subject to §1129 requirements, including the absolute-priority rule. *SPM* arose in the context of an attempt by a lender and creditors’ committee to enforce a proposed carve-out agreement negotiated in a chapter 11, post-conversion to chapter 7 and the bankruptcy court’s decision to order the turnover of the carve-out proceeds at issue to the chapter 7 trustee for the benefit of the entire bankruptcy estate.

<sup>27</sup> *Id.* at 75.

<sup>28</sup> While *Iridium* did not involve a 363 sale *per se*, but rather a preplan settlement dividing rights to pursue causes of action (among other things), it nevertheless appears from the opinion that preplan 363 sales would be subject to its standards in cases in the Second Circuit.

<sup>29</sup> *Iridium* at 459.

<sup>30</sup> *Id.*

<sup>31</sup> *Id.* at 464.

<sup>32</sup> *Id.* at 464-65. The court ultimately found that based on the record before it, the debtor and committee had not articulated sufficient “specific and credible grounds” to support the deviation from the absolute-priority rule and so remanded to the bankruptcy court to consider evidence on that issue.

<sup>33</sup> See *In re Fremont Battery Co.*, 73 B.R. 277, 279 (Bankr. N.D. Ohio 1987) (finding no sound business purpose to approve sale as required under §363 since sale would not benefit unsecured creditors as whole); *In re Encore Healthcare Assoc.*, 312 B.R. 52, 57 (Bankr. E.D. Pa. 2004) (Lionel’s sound business-purpose test for approval of 363 sale must be met in order for sale to be approved, and proposed sale would not be approved where it would result in no sale proceeds being allocated for benefit of unsecured creditors); *In the Matter of Golf LLC*, 322 B.R. 874, 878 (Bankr. D. Neb. 2004) (recognizing that there is no reason to approve 363 sale unless some equity, after payment of secured creditors, will be left behind for benefit of estate and unsecured creditors).